

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of')
ROBERT J. SAVAGE) No. 84A-609

For Appellant: Thomas A. Rohde
Enrolled Agent

For Respondent: **Alison M. Clark**
Counsel

O P I N I O N

This appeal is made pursuant to section 18593^{1/}
of the Revenue and Taxation Code from the action of the
Franchise Tax Board on the protest of Robert J. Savage
against a proposed assessment of additional personal
income tax plus penalty in the total amount of \$1,591 for
the year 1978.

1/ Unless otherwise specified, all section references
are to sections of the Revenue and Taxation Code as in
effect for the year in issue.

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The sole issue for consideration in this appeal is whether the total amounts distributed to appellant from a qualified profit-sharing plan and trust were paid on account of separation from the service of his employer so as to qualify such amounts for special capital gain treatment under section 17503 and for the benefit of seven-year income averaging under section 17112.5.

In 1978, appellant was a principal officer and a major stockholder of Blue Max Aviation, Inc. (Blue Max), a corporation organized under the laws of the State of California, and the parent corporation of Redwood Aviation Enterprises, Inc. (Redwood), and Nation Flight Service, Inc. (Nation). Appellant was also the president and general manager of Redwood. At that time, Redwood had a profit-sharing plan and trust which constituted a qualified trust under section 401(a) of the Internal Revenue Code of 1954 and sections 17501-17503 of the California Revenue and Taxation Code, and appellant was a participant in that plan. 2/

On February 23, 1978, appellant submitted his written resignation as president and director of Nation

2/ Section 414(b) of the Internal Revenue Code provides, in pertinent part, as follows: "[F]or purposes of sections 401 . . . all employees of all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a) ...) shall be treated 'as employed by a single employer.'" Internal Revenue Code section 1563(a) defines the term "controlled group of corporations" to mean a: (1) parent-subsidiary controlled group; (2) brother-sister group or (3) a combined group. Although the record is not entirely clear, we assume that the Redwood plan was the only plan offered to employees of the parent company (Blue Max) and the two subsidiaries (Redwood and Nation). As provided in sections 414(b) and 1563(a) of the Internal Revenue Code set out above, employees of a controlled group of corporations, such as a parent and one or more subsidiaries connected through stock ownership with a common parent, are treated as being employed by a single employer. Thus, although in form there were three separate legal entities involved in this appeal: Blue Max, Redwood, and Nation, for purposes of determining whether appellant was separated from the service of his employment at the time the distributions were paid to him, the three corporations will be treated as one and appellant will be treated as having been employed by a single employer.

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effective February 28, 1978. (Resp. Br., Ex. B.)^{3/}
Appellant sold his shares of common stock in Blue Max back to the corporation pursuant to a contract executed on September 21, 1978. The contract provided that the installment payments for the purchase of appellant's stock were to begin on April 1, 1978. The contract also provided as follows:

9. ROBERT J. SAVAGE shall remain employed by BLUE MAX AVIATION, INC., in the capacity of consultant, at a salary of \$1.00 per year. BLUE MAX AVIATION, INC., shall continue to furnish medical insurance coverage to ROBERT J. SAVAGE, at its expense, to an (sic) including March 31, 1980.

During 1978, appellant received a lump-sum distribution from Redwood's profit-sharing plan in the amount of \$22,392, the entire balance in his account. Appellant did not report this distribution as income on his 1978 California personal income tax return. Following an audit by respondent, appellant filed an amended 1978 personal income tax return on April 14, 1982, and included the lump-sum distribution in his income as \$12,758 of ordinary income and \$4,817 as capital gain income pursuant to section 17503. In addition he used the seven-year income averaging provision of section 17112.5.

After an examination of appellant's return, respondent determined that the lump-sum distribution did not qualify for capital gain treatment and recharacterized the amount received as ordinary income. Respondent also disallowed any income averaging for the year at

^{3/} The resignation letter dated February 23, 1978, provided as follows: "I hereby submit my resignation as President and Director of Nation Flight Service, effective February 28, 1978." A letter dated April 1, 1982, and signed by Mr. Gary Musco, president of Nation, stated that appellant was terminated as an employee of Nation Flight Service on March 31, 1978. The letter also states that "Mr. Savage's resignation as president and director 'was effective in February 1978' (Resp. Br., Ex. C). Although it is not entirely clear from the record, we assume that appellant's resignations as president and general manager of Redwood and from his position at Blue Max were also effective at this time.

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issue. A proposed assessment was issued for additional personal income tax in the amount of \$1,591, including a five percent negligence penalty. Appellant protested, and, after reconsidering the proposed assessment, respondent denied appellant's protest. This timely appeal followed.

Respondent argues that appellant has failed to establish that he received a total distribution from the employee's profit-sharing plan and trust on account of his separation from his employer's service such that the amounts qualify for special capital gain treatment under section 17503. Subdivision (b) of section 17503 accords capital gain treatment to certain distributions from a qualified employees' pension plan when the distribution is occasioned by the employee's death or other separation from the service of his ~~employer~~^{4/}. In this respect it is identical to section 402(a)(2)^{4/} of the Internal Revenue Code. It is well established that when identity or even substantial similarity exists between California and federal law, the interpretation and effect given the federal provision are highly persuasive as to the proper application of the state law. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941); Rihn v. Franchise Tax Board, 131 Cal. App.2d 356, 360 [280 P.2d 893] (1955).) Whether or not such a "separation from the service"* has occurred has been considered previously by both the courts and this board.

The phrase "separation from the service," within the purview of section 402(a)(2), has been interpreted on several occasions. In Fry v. Commissioner, 19 T.C. 461 (1952), affd., 205 F.2d 517 (3rd Cir. 1953), it was found that a separation from the service does not occur where there is continued performance of services coupled with continued receipt of the same compensation. Other interpretations were made in Revenue Rulings 56-214 (1956-1 C.B. 196) and 57-115 (1957-1 C.B. 160) which concluded generally that there must be a complete severance of all relationships between the employer and the employee. Rendition of **services** or being employed to render services and not the element of compensation was

4/ For **federal** purpose% the Employee Retirement Income security Act of 1974 (**ERISA**) (Pub. L. No. 93-406, 88 Stat. 829) changed the rules applicable to lump-sum **dis-**tributions. However, the question of separation from the service under pre-ERISA and post-ERISA decisions is still viable.

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cited in the rulings as the critical factor determining whether or not there has been a separation from service. The rulings also concluded that a lump-sum distribution from a qualified plan, terminated by reason of a corporation's change in business activity, is taxable at ordinary income tax rate's in the case of an officer-employee who continued to serve in a limited capacity as an uncompensated officer-director. In Bolden v. Commissioner, 39 T.C. 829 (1963), it was held that an agreement by an employee to stay in the service of his employer in an advisory and consulting capacity, even though the only actual service performed consisted of answering questions about certain customers after the employee had become employed by a second company, precluded finding that a separation from the service had occurred. However, in Enright v. Commissioner, ¶ 76,393 T.C.M. (P-H) (1976), a petitioner who continued to serve as president of his company after its sale, **but was** not an employee of the purchaser company, was considered to be separated from service within the meaning of section 402(a) (2) because the sale of the corporation caused a substantial and radical change in his employment relationship. In the Appeal of Morris A. and Mary Orbach, decided by this board on **December** 11, 1979, we found that a separation from service did occur when there was a good faith retirement decision made, an actual separation from service, and then a subsequent return to service (after only a few days' absence) as a "new employee."

These examples demonstrate that a **separation** from service does not occur whenever the employment relationship can be said to have continued. Where there is evidence of the continuance of the employment relationship, even without significant compensation, it cannot be concluded that a separation from service has occurred. The question which must **be** determined in the instant case is whether, by reason of the stock buy-out contract, appellant can be said to have continued the employment relationship.

Appellant argues that a true separation from service did occur because no further services were performed for the corporation in any capacity and no compensation was received. Respondent argues that the employment relationship continued by virtue of the contract entered into between appellant and Blue Max.

In the instant case, when appellant resigned his various positions from the parent company and its subsidiaries, he was also the owner of a substantial

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number of shares of common stock of Blue Max. In addition to the provision which provided that appellant would remain employed in the capacity of consultant, the contract provided for the method of buy-back for the stock, severed appellant's interest in the real property of the company, and provided for a covenant not to compete or **engage** in any activity adverse to the company's interest and released appellant from certain liabilities to the various corporations. The contract further provided that during the buy-back period, the stocks would be treated as treasury stocks and voted by the company's board of directors rather than appellant. (See Resp. Br., Ex. D at 3.)

According to respondent, the terms of the contract established unequivocally that appellant had not completely severed his employment relationship with his employer. It argues that the fact appellant was employed as a consultant and was kept on the company's medical plan is ample evidence to show that there was no separation from service. For the reasons stated below, we agree with respondent.

As **respondent** points out, rendition of services or being employed to render services and not the element of compensation is the determinative factor in seeking to establish whether or not there has been a separation from service. (Rev. Rul. 57-115, supra.) **In this case,** although appellant states there was no rendition of services, the contract does provide for his availability to the corporations as a consultant and limits his activities with competing companies. The fact that no services were performed or that the company did not call on appellant for his services is not fatal to a finding that the employment relationship continued. (Cf. **Bolden v. Commissioner**, supra, 39 T.C. at 832.) It is also significant that the provisions of the contract were effective on April 1, 1978; therefore, there was **no** break in appellant's employment relationship. Taken as a whole, we must conclude that a separation from service did not occur.

On the basis of all the foregoing, we must conclude that appellant did not terminate his employment relationship and was not separated from service under section 17503. As such, respondent's action on this issue is sustained. Since appellant has the burden of establishing that the negligence penalty was improperly imposed, and has not presented any significant evidence in- refutation (see Appeal of Myron E. and Alice Z. Gire,

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Cal. St. Bd. of Equal., Sept. 10, 1969), respondent's action in this respect must also be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and **Taxation** Code, that the action of the Franchise Tax Board on the protest of Robert J. Savage against a proposed assessment of additional personal income tax plus penalty in the total amount of \$1,591 for the year 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day
Of November , 1985, by the State Board of Equalization,
with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett
and Mr. Harvey present.

<u>Ernest J. Dronenburg, Jr.</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member
	, Member

*For Kenneth Cdry, per Government Code section 7.9